RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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LETTER 1337

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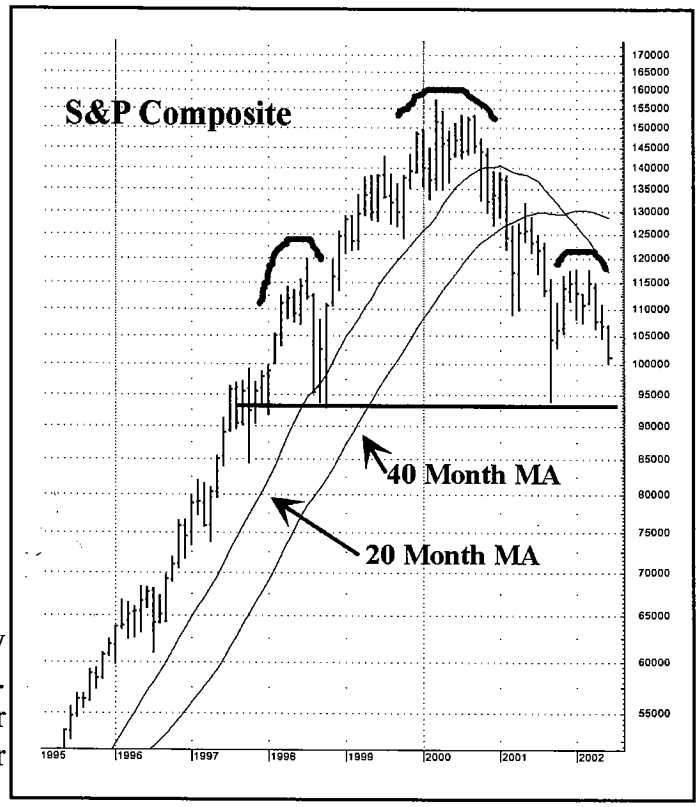
May 31, DJIA 9925.25; PTI 5284; A-D Ratio +2.92
June 7, DJIA 9589.67; PTI 5278; A-D Ratio +1.96
June 14, DJIA 9474.2: PTI 5273; A-D Ratio +1.25
S&P Yield: 1.59% S&P p/e: 40.80
Gold 50-Day MA: 313.80

CRITICAL CHART -- This is probably the most important single chart at this time. Here we see the S&P Composite monthly. The S&P has formed a huge head-and-shoulders top, and the S&P is now "working" on its right shoulder. Over recent months the right shoulder has looked increasingly weak.



The support for the S&P comes in at around 940 in the vicinity of the September low. If or when the S&P breaks below 940, I believe the second phase of this bear market will be on in full. How far down the market will be headed, I don't know.

Note that I have also included the 20-month moving average of the S&P and the longer-term 40-month moving average. In November 2001 the 20-month MA crossed bearishly below the 40-month MA. I consider this as putting a "ceiling" over the S&P. Both moving averages are now trending down in bearish fashion.

THE PICTURE – I called a bear market under Dow Theory on September 23, 1999. That was almost three years ago. Since VALUES DETERIORATE THROUGH TIME in a bear market, it seems to me that the Dow, the strongest of the major averages, has been living on borrowed time.

Or to put it another way, the Dow has been the major strength of this market, even while the other major stock averages have been beaten down by the bear. Somewhere ahead I believe the Dow is going to make up for lost time. As I write the S&P is down 9% for the year, the broad Wilshire 5000 is down 7.26% for the year, the Nasdaq Composite is down 19% for the year – but the Dow is only down 2.5% for the year.

The public relates to the Dow. Ask the man on the street where the S&P is or where the NYSE Composite is, and you get a dumb look. But ask him where the Dow is, and you might get a reasonably correct answer. Or at least, this guy or gal will be able to tell you whether the Dow is above or below 10000.

I think the resistant Dow is one of the reasons why the stock-buying public has remained so remarkably, stubbornly, everlastingly bullish. Despite the fact that a great many stockholders have "lost their shirts" in this market so far, the public remains amazingly bullish.

What this tells me is that this market is in the second psychological phase of the bear market, and probably rather early in the second psychological phase. The second phase of a bear market is the phase where stocks go down as they discount deteriorating corporate earnings. In the second phase (it's almost always the longest phase of a bear market), public sentiment turns from optimism and hope to frustration – from frustration to fear, then from fear to anger and finally to full agreement that "yes, this is indeed a bear market."

The next question is – how do we survive a primary bear market? I wish I had the ultimate answer, but I don't. I can tell you my own strategy. My strategy entails the process called COMPOUNDING. I use the compounding process as my defense against the bear and as my defense against the predatory actions of the Federal Reserve.

As the economy continues to deteriorate, as the recession deepens, I think we will find the Fed frantically fighting the bear forces – fighting those forces tooth and nail. How will the Fed fight the bear forces? They'll fight the bear with inflation of the money supply and with low interest rates.

The world is now in a battle to export. Every nation wants to export its goods and merchandise, and to do this they like to have one advantage. That advantage lies in the area of a lower (competitive) currency. For this reason, as the recession and I believe it will be a world recession, moves on, I think we'll experience a battle of competitive currency devaluations.

This coming battle is not lost on the world of gold. Devaluations mean that it takes an increasing amount of paper (or stocks) to buy an ounce of gold. As currencies devalue, gold will rise. In the last Letter I included a chart showing that in July 1999 the Dow would buy 44.7 ounces of gold. As I write, the Dow at a value of 9650 will buy 33 ounces of gold. As the bear market matures, I believe we could see the time when the Dow will buy close to one ounce of gold. This last occurred in January 1980 when the Dow was in the 700s and gold was also in the 700s.

And you might reply, "Russell, have you lost your mind? At what price would the Dow and gold have to be in order for the Dow to buy one ounce of gold again?" My answer is, "I don't know. The Dow at 4000 and gold at 4000? The Dow at 3000 and gold at 3000? I won't even guess at the levels the two items will have to move to; I'll only venture that before this bear market is over, the Dow will only buy around a single ounce of gold."

Which brings me to that question again – How do we survive this bear market? My answer – you buy the safest high yielding securities that you can find, and you also buy gold shares, maybe 5% to 10% of your total net worth in assorted gold shares.

As for the high-yielding safe securities, you'd have to include US treasury paper in this mix, maybe 5 year or even 10 year T-notes. Some investors may prefer preferred stocks, some may want top-grade utility stocks, and other may prefer TIPS, which are inflation-adjusted Treasury paper.

As a rule, the simpler your "survival plan" in a bear market, the better. Over the last three years, for instance, cash has beaten stocks. Cash? Yes, just dollars in a money market fund or in Treasury bills. That's about as simple as it gets. It's well to remember that old Russell adage, **"In a bear market everyone loses, but it's the person who loses the LEAST who is the winner."**

That may sound very cynical indeed, but I never meant it to be cynical. I meant it to drill home the truth to my subscribers, and believe me – it is the truth. Before this bear market is over almost everyone will have lost money. You can lose money in the value of your home, you can lose money as the value of your cars plunge, you can lose money in your stock portfolio, you can lose money in your business, you can lose the equivalent of money in your health, and your health, of course, is your single most precious possession.

To diverge a bit into philosophy, I've often thought that God meant this to be a democratic world. How did he do it? He did it with one simple stroke. And here it is – I don't care if you're the most pitiful beggar on Telegraph Hill in San Francisco, I don't care if you're Warren Buffett or Bill Gates, you're both going to face the same future – and that future is that you're both going to die.

Death is the essence of equalization and democracy. It falls to every man and woman on the planet. True, the quality of life while we're alive can differ hugely, but who can say whether Bill Gates or the beggar on Telegraph Hill will live longer? Yes, God is the great equalizer and an equal-opportunity democrat. No matter how we live, we all end up the same way – walking up that stairway to heaven.

To get back to survival in a great bear market (which is what I think this bear market will be), it's partly a matter of luck. Events will occur as this bear market moves along that nobody will, at this time, expect. Those events will impact on our portfolios and on our plans.

As I write this I just got word that Bethlehem Steel will be delisted from the NYSE and switched to the over-the-counter bulletin (BS is in Chapter 11). Back in the 1960s "Bessie Steel" was one of the hottest stocks on the NYSE. One of my best friend's fathers was the NYSE specialist in Bethlehem Steel on the NYSE. To be the specialist in this "hot" stock was to make an excellent living. If anyone had told me that I'd see Bessie sinking to around a buck a share and then delisted, I wouldn't have believed it. I would have thought it impossible. I can hear myself saying; "Bessie delisted? The day they do that they'll close the New York Stock Exchange." Think again, the exchange will stay open and Bethlehem will indeed be delisted.

In fact, I just received a letter from an old-time member of the NYSE. He sent me the news of the Bessie delisting, and he wrote in big letters on the page – **WOW!**

So brace yourself, because before this bear market is over, you and I are going to see some amazing changes.

NOTES & QUOTES – Interesting rumor or thesis. Bush is working with Putin of Russia on a deal where Russia would replace Saudi Arabia and the Mideast as THE major supplier of oil to the US.

Most people don't know that at present this is how our foreign suppliers of oil to the US stand. First is Saudi Arabia supplying 17.6% of all US oil imports. Mexico (that's right, Mexico) is second supplying 15.1% of US oil imports. Third is Canada at 14.4%. Fourth is Venezuela at 14%. Fifth is Nigeria at 8.9%. Sixth is Iraq with 8.5%. Seventh is Angola at 3.4%. Eighth is Norway at 2.9%. Ninth is Columbia at 2.6%. Tenth is the United Kingdom at 2.5%.

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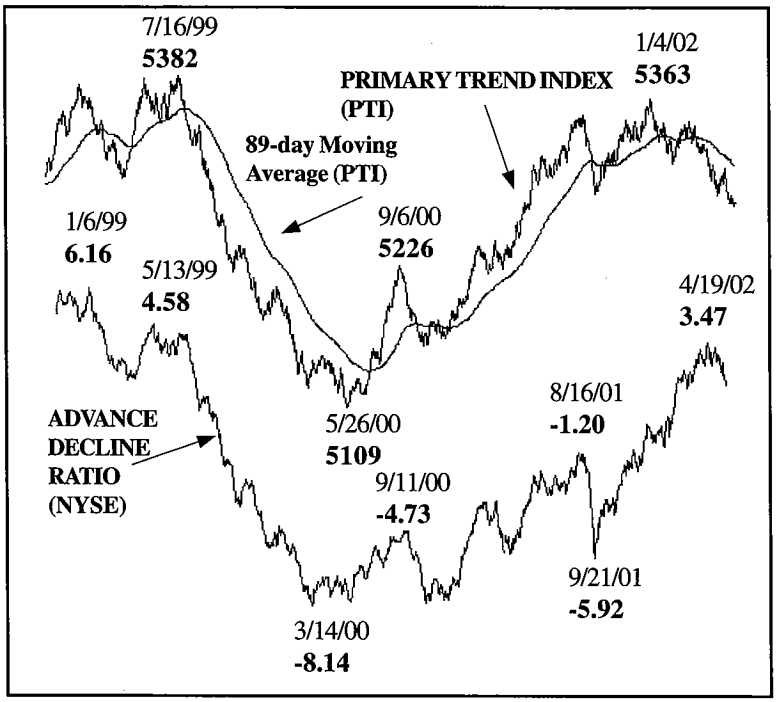
The US imposition of steel tariffs has shaken the faith of the world in the US's commitment to free trade. And it has brought angry reprisals from at least five other nations. A second ugly mess is that $180 billion farm bill, which is basically a subsidy to large farm interests, making it one of the biggest "pork bills" in history. Both bills were vote get-ers and basically political vote-get-ers. It's said that Bush never met a spending bill that he didn't love.



I believe a lot of the Bush spending spree is based on his father's failure to get re-elected, a failure that he blames on Alan Greenspan when he tightened up on credit prior to the presidential election. Bush Jr. wants the economy to be roaring as he heads into his own re-election, and I believe he's pushing Greenspan to keep the money spigots wide open.

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The frenzy to build new sports stadiums may finally have hit a brick wall in the form of the bear market. Plans for a new facility in St. Louis fell apart over public financing. San Diego's Chargers football team was expected to be lured to Los Angeles, the NFL's second biggest market in the US. But financing plans for a new LA stadium fell apart last week, when the private group that was planning the financing backed out.

City after city has found that new ballparks do not always bring a sustained increase in attendance. Ticket sales often spike for a year and then drop off. This has been the experience with new stadiums in both Milwaukee and Pittsburgh. Similar patterns are seen in Detroit, Cleveland and Baltimore.

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Do you believe in astrology? Arch Crawford, a serious astrologer and market student, writes the following in his June 3 *Crawford Perspectives* – "Some of the most powerful astronomic combinations in ALL RECORDED HISTORY will be culminating over the next three weeks!" And that's the word from the stars.

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Of the 500 stocks in the S&P Composite, only two firms, Boeing and Winn-Dixie, allow in their accounting for costs in issuing options. But if option costs are included, some startling earnings result. For instance, if options costs are included, Cisco would report a loss rather than a profit of around 40 cents a share. Microsoft would report earnings in 2001 of $1.40 instead of $1.80. IBM would report earnings of $3.70 instead of $4.30. And AOL Time Warner would have reported earnings of 85 cents instead of $1.19. As for price earnings, for example, instead of earnings growth Microsoft last year would have reported a decline and price/earnings of 49 instead of 29.

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Complacency – One of the most mysterious phenomena at present is the incredible complacency that has accompanied this market. It is estimated that those who bought the market in 1995 and held their stocks are now showing a profit of only 10%. Those who bought the market during 1999 and 2000 at the height of the bubble phase are now showing losses.

Yet through all this frustration and pain, investors have remained stubbornly, unaccountably bullish. In all the years that I've been watching markets, I've never seen anything like this complacency or should I call it just plain bullishness?

How to account for it? The newspapers, TV and the media in general continue to report bullish news about the economy. Greenspan and the Fed continue to announce that the recovery is underway. This generation of analysts, strategists and economists have never experienced or lived through a primary bear market. Lacking the experience, somehow they don't seem to believe a bear market can "happen."

The bear market lows were recorded last September. So far, the main stock averages have held above the September lows. This has given rise to the thesis that despite disappointments and problems, the September lows marked the worst of

the bear market decline. This thesis has also allowed for hope and bullish interpretations.

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Will everything eventually be made in China? China's wages are one-third that of Mexico's and 5% of the US's and Japan's. China's investments in education and research are attracting research facilities from major corporations around the world. According to Bear Stearns, by 2010 50% of all US manufacturing could be exported to other nations, and it seems as though the favored nation will be China.

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The hero of September 11 is ex-New York mayor Rudy Giuliani. Now Bruce Teitlebaum, Rudy's most trusted political advisor, is saying that Giuliani may be part of the 2002 "dream team." And what's the dream team? Why it's Bush and Giuliani. Furthermore, Teitlebaum predicts that Guiliani will be running for president in 2008. Do you believe it? It wouldn't surprise me. Meanwhile, Guiliani keeps running, keeps speaking, keeps making West Coast trips. Who knows where it will all end.

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The worst mistake made during the bubble years of the late-1990s is widely thought to be Time Warner's agreement to be taken over by AOL. In December 1999 the stock sold as high as 93.88. This morning AOL sold for 16.50, down 80% from the high. How could an overpriced Internet stock have taken over the largest media company on the planet? As one observer put it, "What were the Time Warner directors smoking?"

INVESTMENT POSITION — How do you handle your money in a primary bear market? That, of course, is the problem facing investors today. Here's my own answer. It's obviously not the perfect answer, but it's what I personally am doing. As subscribers know, I bought top-grade municipal bonds a few years ago. I did this on the thesis that top-rated municipal bonds paying up to 6% were worth 12% to me in California, which is a very high-tax state.

My other consideration was this and I've repeated this over and over – I believe we're going into a big bear market, a bear market that will be accompanied as we go along by hard times. It's difficult for me to believe that stocks can collapse while the economy remains healthy. I just don't think it's going to happen.

I also said that as this bear market moves along the operative word is going to be INCOME. Everybody is going to need income. This was part of my thinking in buying top-grade municipal bonds. I also thought that the Fed in order to attempt to stimulate business would bring short rates down as far as it was possible to bring them. At the time everyone was warning about a rising cycle of interest rates. I didn't agree. I thought rates would go lower as the Fed fought "tooth and nail" to re-stimulate the economy, or as some put it, the Fed's fight "to bring back the bubble."

So my first move was to load up with muni bonds. My second move was to buy gold shares. Now frankly, I don't know whether anyone at this stage of the gold bull market can pick the ultimate winners. I have posted a list of gold shares that I like, and I suggested that subscribers buy at least five different gold shares. It's foolish to depend on one or two gold shares, on the premise that you are smart enough to pick one or two of the ultimate winners.

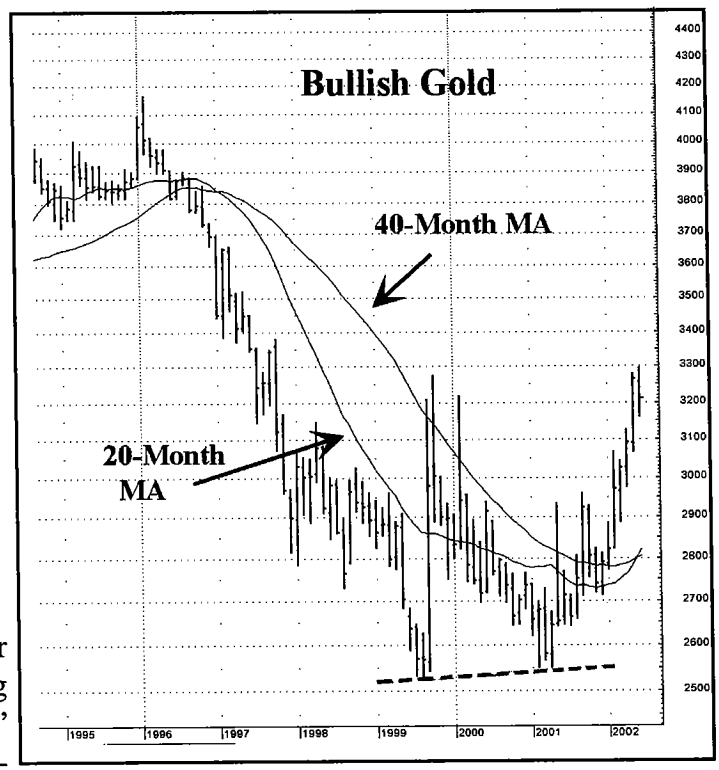
Then there is the necessity to compound your money. The Fed has been going on a liquidity-creating spree. That isn't a guess, it's a fact. Greenspan and company have added over a trillion dollars in liquidity to our markets over the last year. As the bear market moves on and as losses increase, I'm guessing that the Fed will continue to flood the market with liquidity.

Thus we face one of two possibilities. The first – stag-flation. This is a situation where the economy is stagnant, going nowhere, but Fed-created inflation continues full steam ahead. In this situation stocks continue down, and well, losses just continue to build up. The second possibility is that the market and the economy both tank, and at the same time the Fed continues to create more and more liquidity.

I don't know how bonds would act in either situation. If the dollar falls apart, then interest rates would normally move higher, since it would require higher interest rates to keep our foreign friends putting their money in dollars. That would clearly hit bonds, and bondholders would just be in the position of sitting with their bonds until either rates came down or their bonds matured.

It is extremely important, however, that you compound your income. You must depend on the massive power of compounding to make up for any losses that you may sustain because of the Fed's inflationary policies. In a bear market, you're best defense is to utilize the power of compounding. I can't emphasize that concept enough. Of course to do this you must not spend more than your income. In other words, you've got to have something to compound with. That "something" is your income after deducting expenses.

GOLD – This is a monthly chart of gold. Here we see that the 20-month moving average crossed below the longer 40-month moving average back in February 1997. The relationship of the two moving averages lasted until May of 2002, a period of over 5 years. Now with the 20-month MA finally crossing above the 40-month MA, I would guess that this relationship could last 3, 4 or 5 years.



The gold price has surged far above both moving averages, and this could mean a period of consolidation. But the bullish crossing of the moving averages indicate that a new bull market is in place. The long-term trend of gold is now bullish, this despite the fact that gold is overbought and in the process of correcting.

LATE NOTES – One ironic (nasty) nuance of this bear market is that day after day it gives stockholders something to hang their hopes on. "Hey, the market closed off its lows." "The breadth wasn't that bad." "Look, new lows didn't expand." "General Motors says that car sales are looking better."

Hope, hope, hope — it's what keeps people sitting and losing in a bear market. People ask me, "Russell, what do you think I should do with my stocks? If I sell them here, I'll have fat taxes to pay." And my answer is, "If you sit tight with your stocks, in a year or so you won't have any tax problems to worry about. The bear market will make sure of that."

The hero of the bear market, so far (as I suspected they would be) have been bonds. Bonds provide income, and the operative word in this bear market is going to be INCOME. Everybody needs it, and you can't get it in stocks, you can't get it in money market funds and you can't get it in real estate. That leaves bonds. My prediction – we'll see the 10-year Treasury note break below the 4% yield barrier before this bear market breathes its last.

Next mailing: July 10, 2002